The Concerns with Going Concern

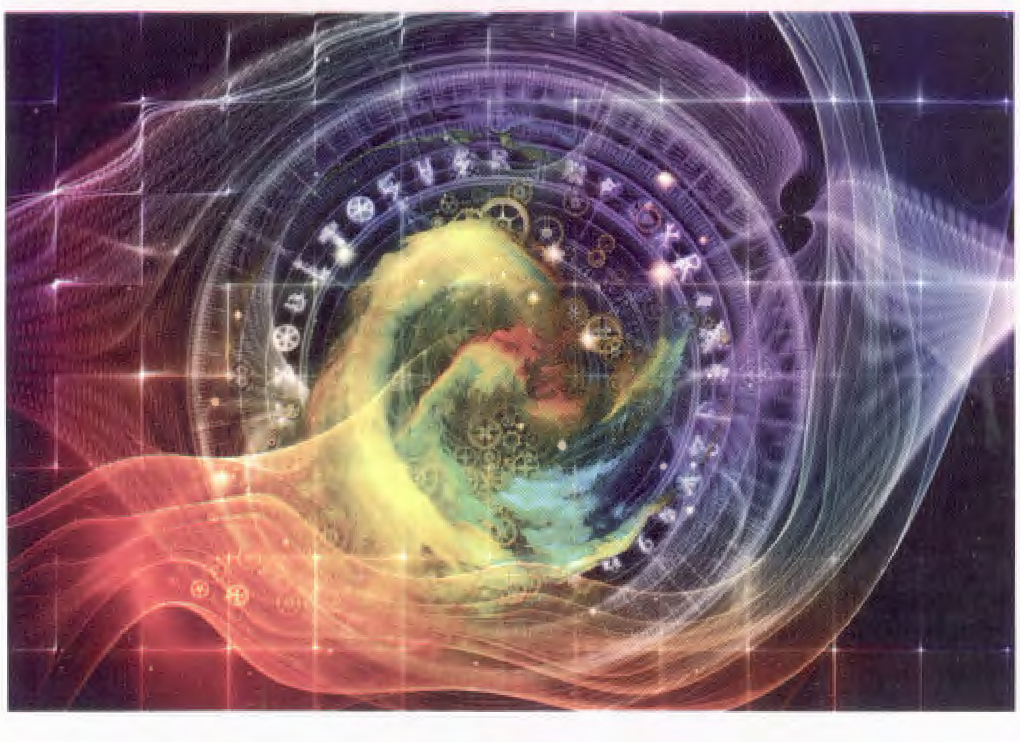
By John H. Eickemeyer and Vincent J. Love

"The only function of economic forecasting is to make astrology look respectable." —John Kenneth Galbraith

"Economists are about as useful as astrologers in predicting the future (and, like astrologers, they never let failure on one occasion diminish certitude on the next)." —Arthur Schlesinger Jr.

While humorous and tongue-in-cheek, these quotes by a foremost economist and U.S. historian highlight the problem with the financial accounting for and the auditing of an entity when there is uncertainty regarding its ability to realize the value of its assets and liquidate its liabilities at the amounts stated in its financial statements. Forecasting the economy—and, therefore, its effect on an enterprise's existence—is problematic. The same can be said for microeconomic forecasting.

A basic concept in financial reporting is the assumption that an entity will continue in existence long enough to use its existing assets and discharge its liabilities in the normal course of doing business (i.e., the going concern assumption). Macro- and microeconomic forecasting play a significant role in evaluating the reasonableness of this assumption.



The Going Concern Assumption

Though this assumption is conceptually easy to articulate, it is often extremely difficult to determine when an entity's continuing existence is in such doubt that management needs to disclose that possibility in a note to its financial statements, and its auditors need to modify their report to acknowledge that risk. There also exists the very real possibility of creating a self-fulfilling prophecy when questioning an entity's ability to continue to operate into the future. Such a disclosure can hasten the entity's demise by impairing its ability to obtain credit, in turn causing current and potential customers to hesitate to enter into transactions with it. The end result can be that the entity must dispose of its operating assets outside the normal course of business to meet its obligations, eventually causing it to go out of business and liquidate.

If the auditor, when performing an audit, determines that there is "substantial doubt" that an entity can exist through the "forward-looking period," after considering any plan by management to address this issue, a going concern emphasis or explanatory paragraph (or qualification) will be required in the auditor's report. The *Exhibit* compares the various forward-looking periods under the different standards for evaluating continued existence (paraphrasing the actual standards that need to be consulted in making the determination). The major issue, however, is not the length of the forward-looking period, but the capability of the auditor to assess management's evaluation and determine its reasonableness. All forward-looking analyses are subject to error and the dynamics of changing—and sometimes unpredictable—macro- and microeconomic factors.

GAAS is clear in its affirmation that an auditor is not an oracle who can accurately predict future business and economic events. The standards also recognize that an entity's failure within the forward-looking period, even though the auditor did not address a substantial doubt about the entity's ability to continue to exist in its report, "does not, in itself, indicate inadequate performance by the auditor."

Going Concern Disclosure

Currently, two questions bear on the continuing applicability of this basic assumption: 1) what is the going concern issue's importance in today's information age, and 2) how will courts assess liability claims against auditors if the entity fails before the end of the forward-looking period?

The going concern assumption is essential in establishing the value of an entity's assets and liabilities. The length of the forward-looking period matters because financial statements lose their relevance when updated audited financial statements become available. However, the rapidly increasing number, velocity, and complexity of business transactions that can occur in a short period of time after the close of the business year and the issuance of the audited financial statements—or even after the issuance of the auditor's report on the financial statements—change the dynamics of data analysis.

Today's information age continues to radically and rapidly transform business. The advent of enhanced technology has created a greater ability to develop, value, and understand the components of intricate financial and other real and synthetically derived transactions. These changes have given rise to novel techniques to value and revalue assets and liabilities to make them more closely approximate their true worth at any particular date. Accounting and auditing standards have changed to address these innovative products to make financial statements more meaningful. Historical cost is no longer the only—or, in some cases, the prevalent—basis for valuing the components displayed on financial statements. Further, the information now available on virtually any subject is limited only by an individual's skill in searching the Internet and other research sources. This timely and more comprehensive information is available to absentee owners, shareholders, and lenders who make the generally minimal effort required to access it.

Publicly Held Companies

More, and more current, information on the operations and financial soundness of public companies is available to any interested party before making any investment or lending decision. Regulators, recognizing the importance of more and timelier data, have shortened the period for reporting year- or quarter-end financial statements and have increased the information companies must disclose. It is important to note that, if appropriate, going concern disclosure is also required in quarterly financial statements. Securities and lending institutions' analysts can—and most often do—scour the Internet for information on an entity, its competitors, and its industry. They also search for employee websites, social media, and blogs that might provide information on an entity and its operations.

Thus, the audited financial statements have lost a great deal of their prominence as a source of current data on the operations of an entity. Yet they still maintain their status as the most reliable source of data as of the financial statement date and of the entity's performance and significant events during the period covered by the financial statements (or in the 60-day window following the year-end and the required 10-K filing with the SEC). Any investor, investment advisor, or loan analyst can—and most often does—obtain more current information before making an investment or loan decision.

The amount of data now available places a prudent investor or lender in a position to make a reasoned determination about an entity's ability to continue as a going concern, with more current financial data than was examined by the auditor as of the date the financial statements are issued. The financial statements are not the only, or the most current, source of information from which to make an investment decision.

Privately Held Companies

The amount of information available to investors in, or lenders to, private companies is generally not as great or as current as that available concerning publicly traded companies; however, information is available to lenders or absentee owners beyond that found in previously issued financial statements. An owner-manager is present and operating the business on a day-to-day basis and should be fully aware of any substantial doubt concerning the ability of the entity to realize its assets and liquidate its liabilities in the normal course of business. An absentee owner usually has access to the entity's records and can speak to management.

Lenders are in a position to evaluate a prospective borrower's financial condition and ability to repay the loan, and they generally have their own procedures for doing so. Lending institutions have analysts who evaluate a borrower and its financial condition. They conduct significant research and analysis and, most often in tenuous situations, require collateral sufficient to liquidate the debt. They have departments that audit the existence and value of the collateral before the loan is funded and periodically afterwards. They also evaluate the entity's cash flow because they expect to get paid from the entity's operating cash flow.

The owners, management, and financial institutions making investments in, or loans to, the entity in most cases have access to more current data than the auditors reporting on the financial statements. Consequently, the absence of a going concern modification in the auditor's report should not be regarded as a significant factor in any financial decision a lender or owner makes.

Accountants' Malpractice Claims

When an entity ceases to exist, it's common for lenders or shareholders who have sustained losses to blame the auditors for not being skeptical or diligent enough to ascertain that there was a substantial doubt about the entity's ability to survive as a going concern and for failing to disclose such doubts if the auditors harbored them.

However, some courts considering cases in which the plaintiff alleges that the auditors should have issued a going concern disclosure have looked beyond these allegations and assessed what information was available to the plaintiff during the relevant period. For example, in *Devaney v. Chester* [No. 83 Civ. 8455 (JFK), 1989 WL 52375 (S.D.N.Y. May 10, 1989)], the bankruptcy trustee of an entity that had acquired a deeply troubled shipping entity alleged that the entity's auditors should have disclosed a serious doubt about the entity's ability to continue as a going concern. Had the auditors done so, the trustee alleged, the acquisition would never have gone forward.

The auditors moved for summary judgment after discovery, arguing that the acquirers were fully aware of the shipping entity's dire financial condition and a going concern disclosure would not have told them anything they did not already know. In particular, the acquirers had, in conjunction with their underwriter, prepared an offering document circulated to potential financers of the deal. That prospectus detailed the shipping company's continuing losses and cash shortages and stated that, unless fresh capital was found quickly, the entity's ability to continue operations was questionable.

The court granted summary judgment to the auditors and dismissed the claim. It assessed the considerable evidence suggesting that the acquirers were fully aware of the near-insolvency of the entity they were about to purchase and concluded that the going concern disclosure would not have added to the information they already had. The court concluded that because the acquirers decided to proceed anyway, the trustee could not demonstrate that a going concern disclosure would have dissuaded them.

Devaney involved a privately held entity, sophisticated potential financers, and acquirers who had full access to the target entity's financial condition and operations. These circumstances have generally not been applicable to transactions involving publicly traded securities. However, the increased pace and volume of disclosure of up-to-date information concerning publicly traded companies might cause courts today to weigh allegations of a failure to make a going concern disclosure in the context of all of the information available to a plaintiff.

Annual audited financial statements are generally deemed by investors to

EXHIBIT

Different Definitions of the Forward-Looking Period

AU-C section 570.06 (GAAS)	ASU 2014-15 (GAAP)*	IAS 1.25-6 (International)
When the auditor has substantial doubt: one year from the date of the financial statements.	When management determines there is substantial doubt: one year after the date that the financial statements are issued (or within one year after the date that the financial statements are available to be issued).	When management is aware that significant doubt exists (in making its assessment): at least, but not limited to, 12 months from the end of the reporting period.

* Effective for annual periods ending after December 15, 2016, and for interim periods ending thereafter, with early application permitted.

have a certain authority; however, by the time the audited statements are issued, they are effectively "old news" because year-end earnings results are likely to have been released by the time a Form 10-K is filed with the SEC. Only if the results disclosed in the financial statements differ materially from the results disclosed by management, or if there is a disclosed significant event subsequent to year-end (about which information is likely to be available in any event), is an investor likely to be influenced regarding a possible stock purchase—if the investor reads the financial statements at all.

The greater accessibility of timely financial data concerning publicly traded companies should cause courts to view future going concern claims with greater skepticism. Given that the courts assume securities markets to be efficient—that is, disclosures and developments affecting publicly traded companies are promptly factored into the stock price—it is reasonable for those courts to expect that market participants will remain abreast of such developments. The Supreme Court's decisions in *Basic v. Levinson* (485 U.S. 224) and its progeny assume that false information will be factored into market participants' stock purchase and sale decisions. It only seems logical for courts to similarly presume that market participants act with consideration of publicly available countervailing information.

Courts should thus exercise some skepticism about allegations that such transactions would not have occurred if only the auditors had included a going concern disclosure in their opinion or insisted on such a disclosure in the notes. This is particularly true in cases where the plaintiffs are institutional investors who have the capacity to analyze financial data concerning large public companies on a continual basis.

With respect to privately held companies, judicial skepticism about going concern claims should be even greater, given that those contemplating lending or private financing transactions with such companies will likely have even greater access to real-time information concerning the entity than most public-entity investors do. In most such cases, where evidence of the availability of, or access to, real-time financial data concerning the entity is presented, courts should seriously weigh whether justifiable reliance on the absence of a going concern disclosure in audited financial statements can be established. If such an analysis is made, it can be expected that successful negligence claims based on the absence of a going concern disclosure will be few and far between. Indeed, such claims might only succeed on a fraud or recklessness theory, where it could be shown that the auditor was aware of "storm warnings" that should have led to further inquiry and, perhaps, a going concern disclosure.

Technology Diminishes Going Concern Relevance

An auditor needs to be reasonably confident of the continued existence of an entity in order to audit the amounts displayed on the entity's financial statements and contained in the notes. However, the rapidity, complexity, and volume of transactions facilitated by today's technology increasingly affect the continuing reliability of the going concern modification in the audit report the further one gets from the date of the report. This does not mean that the contingency related to any substantial inability to continue in existence for the forward-looking period is not of material importance at the time the financial statements are issued. The going concern assumption is fundamental in accepting the carrying amounts contained in the financial statements. And if, at the time the statements are issued, there is any substantial doubt about the ability to realize those asset values and liquidate those liabilities, disclosure by management in a note and by the auditor in its report is required for a fair presentation.

The relevance of audited financial statements beyond the date they are issued is now often diminished.

The relevance of audited financial statements beyond the date they are issued is now often diminished because the data necessary to determine the entity's financial condition in the period between reports is more extensive than ever. Shareholders, analysts, and lenders can and should research the subsequent operations of the entity and relevant industry before making a decision to invest in or extend a loan to the entity. ❑

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